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M&A in the Banking Industry: Legal Perspective

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M&A IN THE BANKING INDUSTRY: LEGAL PERSPECTIVE *

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INTRODUCTION

Wall Street loves a firing and therefore, we are seeing tremendous consolidation in the financial institutions industry. From the standpoint of advisors and lawyers to the industry, we expect the consolidation to continue. [1] Other speakers, such as Neil McCarthy from Bear Stearns, will address the economics of these consolidations in more detail.

The merger of two financial institutions creates tremendous back office savings. For example, the post-merger company no longer needs two general counsels. Moreover, if you take the traditional ten or eleven multiple for two individual bank holding companies and merge them, Wall Street will give the merged entity a tremendous increase in market capital for the two sets of shareholders from the costs which are saved.

Recently, I have been influenced by two consolidation transactions. Skadden, Arps, Slate, Meagher & Flom represented First Interstate Bancorp ("First Interstate") during the negotiation and signing of a merger agreement with First Bank System ("FBS") and later in its consummation of a merger

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[1] *See* Alan Sloan, Ann Underwood, John McCormick & Deborah Branscombe, *The Hit Men*, NEWSWEEK, Feb. 26, 1996, at 44 (indicating that Wall Street loves layoffs but massive layoffs scare the public and stir political backlash); James McCormick & J. William Bowen, Comment: *Consolidation Is Key To Strengthening Competitive Capacity*, AM. BANKER, June 8, 1995, at 5 (reporting the findings of a study by the First Manhattan Consulting Group: banks are beginning to make consolidation work for the shareholder and are greatly strengthening their position vis-a-vis nonbanks).

transaction with Wells Fargo & Company ("Wells Fargo"), who had launched a hostile bid for First Interstate.[2] The second transaction was the proxy fight brought by CAI Corporation, a dissident shareholder of Commercial Federal Corporation ("Commercial Federal"). These transactions indicate two fundamental changes in the banking industry: the increasing probability of a hostile bid and increasing shareholder activity and pressure.

Financial institutions have done well in the stock market over the past few years.[3] However, shareholders typically now believe that stock prices have reached their peak[4] and that there is greater downside risk than upside potential in many of these institutions. These shareholders have forced companies to pursue mergers or acquisitions as a means to increase shareholder value. Mike Price, President of Heine Securities, is the best known example of a shareholder exerting pressure on an institution.[5]

The number of mergers and acquisitions, including hostile takeover attempts of financial institutions has increased dramatically.[6] However, successful hostile takeovers are rare. Traditionally, "he

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[2] John R. Wilke, *Wells Fargo's Bid for First Interstate Clears Regulators,* WALL ST. J., Mar. 7, 1996, at A4 (indicating that Wells Fargo's bid for First Interstate was spurned by the First Interstate board which favored a subsequent bid from FBS. When the First Interstate - FBS merger failed, Wells Fargo prevailed with an $11.6 billion acquisition which was to create the nation's seventh largest bank).

[3] Justin Fox, *Profits rose 9.4% in Year, Setting Yet Another Record,* AM. BANKER, Mar. 15, 1996, at 2 (indicating that bank profits hit a record $48.8 billion in 1995 and that before 1993, the industry's annual ROA had never broken 1%, not at least since the FDIC began keeping records in 1934); Howard Kapiloff, *Profits at the Top Banks Rose 8.8% Last Year, but Some Took Rate Hit,* AM. BANKER, Mar 24, 1995, at 6; Howard Kapiloff, *Earnings at Nation's Top 100 Banks Increased by 52% in '93,* AM. BANKER, Aug. 18, 1994, at 31A.

[4] Stephen Kleege, *Stocks: Merger Rally Out of Gas? Short Sellers Betting It Is,* AM. BANKER, Sept. 25, 1995, at 1 (noting a growing sentiment in the marketplace that bank stock prices have run their course and are overdue for a downward adjustment).

[5] Robert McGough & Laura Jereski, *Banking: How an Investor Pushed Banks Toward Merger,* WALL ST. J., Aug. 29, 1995, at B1. According to the article, "Mr. Price's pressure on Chase started when he boosted his stake in April. The disclosure of his funds' 6.1% stake in Chase set alarm bells ringing in the executive suite at Chase Manhattan." *Id.*

[6] *Contra* Daniel Kaplan, *In the Year of the Big Deal, Aggregate Value Tripled,* AM. BANKER, Jan. 29, 1996, at 2A (noting that there were more than one hundred fewer mergers and acquisitions last year than in the previous two years, however, the aggregate value of those deals was $73.1 billion, over three times the volume of the previous years).

who starts the fight loses because he forces the target into the hands of someone else."[7] However, I believe hostile takeovers are inadvisable unless the bidder has two advantages over other suitors: superior economics and the willpower to follow through on an often long and difficult process. The existence of these elements will determine whether or not the takeover is successful. Unlike the failed attempt by Wells Fargo in 1994 to acquire First Interstate,[8] Wells Fargo proved in 1996 that it had the superior economics in its stock price, market credibility, and potential for cost savings.[9] Wells Fargo also proved it had the will and the desire to bring the acquisition to fruition.

WELLS FARGO - FIRST INTERSTATE BANK MERGER

In the fall of 1995, Wells Fargo delivered a bear-hug letter[10] to First Interstate outlining its intentions.[11] Wells Fargo threatened to announce its offer unless First Interstate commenced immediate exclusive merger negotiations with Wells Fargo. Immediately following it's rejection of the ultimatum, First Interstate issued a press release setting forth the Wells Fargo offer. The public announcement had the effect of increasing both the price and trading volume of the First Interstate stock.

Normally, behind the scenes negotiation and discussion activity occur well before public announcements and press releases are issued. In this situation, however, Wells Fargo's strategy was to put the offer in the marketplace. Hostile bidders depend upon arbitrageurs to move into the stock of the target.

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[7] Ralph T. King, Jr., *First Interstate Rejected Merger With Wells Fargo*, WALL ST. J., Mar. 4, 1994, at A2 (indicating that regulators dislike drawn out takeover battles that result in weakening the target bank's financial position).

[8] *Id.* (indicating that First Interstate rejected Wells Fargo's 1994 merger proposal, reflecting First Interstate's desire to remain independent).

[9] Ralph T. King, Jr., *Two Tough Bankers Take On a New Mission,* WALL ST. J., Jan. 25, 1996, at B1 (noting that Wells Fargo Chairman, Paul Hazen, and Chief Operating Officer, William Zuendt, vowed to increase cash per-share earnings by at least 30% within 18 months of the $11.6 billion acquisition of First Interstate).

[10] Daniel Kaplan, *M&A: Bear Hugs from Predators Easy to Wriggle Out of*, AM. BANKER, Oct. 25, 1995, at 24. According to this article, "[b]ear hug is a term for an unsolicited letter in which the sender announces its desire to buy out the recipient." *Id.*

[11] *Id.*

It is assumed that the arbitrageurs will vote in favor of the sale of the target company. In financial institution (especially banking) transactions, arbitrageurs are less likely to take the risk of waiting four to six months or longer for a hostile transaction to close.[12] Wells Fargo accomplished its objective of letting the market review the economic advantages of its offer by placing First Interstate in a public announcement scenario.

First Interstate was now faced with the option of declining the bear hug letter or talking to other possible acquirers. A number of institutions contacted First Interstate. Ultimately, three bank holding companies signed confidentiality and standstill agreements.[13] Each of the possible transactions was a stock for stock merger with the shareholders of First Interstate obtaining a significant interest in the combined entity. Since none of the transactions was a sale of First Interstate, First Interstate was not in the so called "Revlon" mode.[14] The Delaware Court of Chancery held, consistent with the Bank of Boston/Society case,[15] that by signing three separate confidentiality and standstill agreements and by entering into talks regarding stock-for-stock exchanges, First Interstate did not enter into a Revlon auctioning mode.[16]

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[12] Daniel Kaplan & Barton Crockett, *Wells' Bid For First Interstate Seen Hurt By Investors' Doubts*, AM. BANKER, Nov. 16, 1995, at 6. According to the article, "[m]any arbitrageurs and traders were said to be closing positions in First Interstate and Wells Fargo, put off by the prospects of a six-month to one-year battle for the Los Angeles bank." *Id.*

[13] *See Wells Fargo: First Interstate Held Talks with NOB, One Issuer: First Interstate Bankcorp,* SELECT FED. FILINGS NEWSWIRES, Nov. 14, 1995, *available in* Westlaw, WL, FEDFILE, 22:08:00 (identifying First Bank, Norwest Corp., and Banc One Corp. as the three banks that signed these agreements).

[14] Janet E. Kerr, Article: *Delaware Goes Shopping for a "New" Interpretation of the Revlon Standard: The Effect of the QVC Decision on Strategic Mergers,* 58 ALB. L. REV. 609, The article states, "Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. is the seminal case with respect to the development of the duty of the board of directors to maximize shareholder value, which is now referred to as the Revlon duty." *Id.*, at 620.

[15] Arnold v. Society for Savings Bancorp, Inc., 650 A.2d 1270 (1994). This case cites Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 47 (1994) in holding that Revlon duties are not triggered when control of the merged entity "remain[s] in a large, fluid, changeable and changing market," even when the target company's stockholders are relegated to minority status in the surviving entity. *Id.*, at 1290.

[16] Wells Fargo v. First Interstate Bancorp, 1996 WL 32169, (Del. Ch. Jan. 18, 1996) (stating that no change in corporate control was implicated in the First Bank System-First Interstate Bancorp agreement and thus Revlon duties were not triggered).

Wells Fargo competed on its stock price as opposed to exchange ratio, floating an exchange ratio which it only increased slightly.[17] Wells Fargo and FBS and First Interstate explained their respective transactions to shareholders and analysts through a number of presentations and question and answer sessions. The market favored Wells Fargo's offer because of its cost savings and economies of scale, and thereby perceived Wells Fargo as the ultimate winner.

Wells Fargo's strategy was to have First Interstate shareholders vote against the FBS transaction.[18] Wells Fargo notified the Federal Reserve Board that it anticipated a negotiated transaction with First Interstate after shareholders voted down the FBS transaction. However, if First Interstate refused to negotiate, Wells Fargo threatened to remove First Interstate's Board of Directors.[19] First Interstate was vulnerable to such an action because its charter did not provide for a staggered board and allowed for consent solicitations by shareholders.[20] However, these factors did not ultimately control the situation, but rather it was the market perception of the superiority of Wells Fargo's bid from an economic perspective. If you have a 12 to 15 percent price advantage by one of the parties, it is going to be of little consequence whether or not the target company has a staggered board. The existence of First Interstate's shareholder rights plan would have necessitated removing the board, because Wells Fargo would not have been able to close its exchange offer as long as the rights plan was outstanding.[21] The First Interstate board never made

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[17] *But see* Ralph T. King, Jr. & Steven Lipin, *Wells Fargo Raises Bid for First Interstate,* WALL ST. J., Nov. 14, 1995, at A3 (indicating that investors were disappointed that Wells Fargo's bid was less than the 0.7 exchange ratio that they had hoped for and that, according to a major First Interstate shareholder, the Wells Fargo offer was clearly better from both the short-term price perspective and on long-term prospects).

[18] Ralph T. King, Jr., *Business Brief: Wells Fargo Files Exchange Offer for First Interstate,* WALL ST. J., Nov. 28, 1995, at B4 (indicating that Wells Fargo hopes to persuade shareholders to reject the merger proposal with FBS by offering them a viable alternative).

[19] *Id.* (mentioning Wells Fargo could use a consent solicitation to replace the current Board of Directors with its own nominees).

[20] *See id.* (comment from Allen Finkelstein, partner at Cravath, Swaine & Moore, legal advisor to Wells Fargo, supporting the viability of such a measure).

[21] First Interstate's rights plan contained a 15% "flip-in" provision, pursuant to which any acquisition by Wells Fargo in excess of 15% of the total outstanding common shares of First Interstate would trigger the issuance of discounted common shares to all other First Interstate shareholders, thereby effectively diluting Wells Fargo's interest.

any decision based upon the potential removal of its members. That was not an issue to the board. The board simply realized that in the takeover context the market overcomes all.[22]

Under the terms of its agreement with FBS, First Interstate's directors retained the right to exercise their fiduciary duties to take three actions, which in the absence of such fiduciary duties would be prohibited ("fiduciary outs"); namely, (i) supplying information to any third party which may facilitate a takeover proposal by that party, (ii) recommending a third party's takeover proposal to the First Interstate stockholders instead of the FBS transaction, and (iii) terminating in its entirety the contract with FBS.[23]

First Interstate exercised the first fiduciary out by supplying information to Wells Fargo when there was an approximate $15.00 spread against FBS' $130.00 price,[24] and First Interstate notified FBS accordingly. Subsequently, as the financial advantages to First Interstate stockholders of a transaction with Wells Fargo became increasingly apparent, First Interstate terminated its agreement with FBS under the third fiduciary out.[25]

James M. Rockett, *Prepping for a Hostile Environment: Measures to Ward Off Unwanted Merger Attempts*, CFO ALERT, Jul. 1, 1996, at 1. This article explains that a shareholder rights plan:

> establishes a threshold of stock ownership (e.g. 10% or 20%) beyond which an individual shareholder ... may not proceed without approaching the board and offering a proposal that can be evaluated by the board for fairness to all shareholders. If the aggressive acquirer exceeds the threshold amount (the 'flip in'), the balance of the shareholders, not including the holder who has exceeded the flip-in, are awarded the right to acquire stock from the treasury of the company for less than the current market value ..., thus severely diluting the holdings of the aggressive acquirer.

Id.

[22] Kaplan, *supra* note 6. According to this article, in the Wells Fargo acquisition of First Interstate, "once-mighty chief executives were humbled; and shareholders and directors, once pawns, became kings in the new age of mergers." *Id.*

[23] *See* James P. Miller, *First Bank's Loss of a Merger Partner is $200 Million Gain,* WALL ST. J., Jan. 25, 1996, at B12 (explaining that FBS received $200 million from settlement of termination provisions contained in "friendly pact" which it signed with First Interstate).

[24] Steven Lipin & Timothy L. O'Brien, *First Bank is Dealt Setback on Bid for First Interstate - SEC Ruling on Buybacks, Wells Fargo Stock Gain Imperil $10 Billion Pact,* WALL ST. J., Jan. 22, 1996, at A3.

[25] Miller, *supra* note 23; *see also* Lipin & O'Brien, *supra* note 24. According to this article, First Interstate can terminate the merger if there is a takeover proposal on the table, and the board "reasonably determines in good faith that termination is necessary in the exercise of fiduciary duties." *Id.*

During the fight for control, Wells Fargo competed with FBS through the stock price. The price spread[26] was in the $15.00 to $22.00 range.

Having successfully negotiated and executed an agreement with FBS, First Interstate anticipated that an important defense to Wells Fargo's hostile bid would be FBS's advantage in obtaining regulatory approval for its friendly transaction versus the customary delayed process inherent in hostile bids. Hostile bidders are at a substantial disadvantage in takeover situations in the financial institutions industry in obtaining the requisite regulatory approvals[27] because the bidders lack the ability to perform due diligence on the target institutions and lack the time to evaluate properly the myriad of complex antitrust issues. The main antitrust concern for Wells Fargo was which branches to divest.[28] Since Wells Fargo had good information about First Interstate from public disclosures and because the industry was doing well, it was prepared to move forward with its exchange offer without extensive due diligence and was able to proceed on a fairly similar time frame as FBS with the approval processes of the federal and state regulators. The market's perception that Wells Fargo was on essentially the same time schedule was critical to the Wells Fargo bid. If Wells Fargo were to be substantially behind FBS, shareholders might have chosen the definite transaction as opposed to one which had not received regulatory approval. Acquiring institutions no longer emphasize due diligence on loans and loan loss reserves, but rather emphasize due diligence on back office savings.[29] For example, they ask, "Does my computer system fit with yours? How many positions can be eliminated? How long will realization of the full cost savings take?"

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[26] The "price spread" here represents the difference in the dollar value in a transaction with Wells Fargo of the Wells Fargo stock which First Interstate shareholders would (or after the closing of the actual transaction, did) receive in a transaction with Wells Fargo over the dollar value of the FBS stock which they would receive in the signed FBS transaction per share of First Interstate common stock.

[27] Jaret Seiberg, *Wells to Shed $2.5 Billion of Deposits for Merger,* AM. BANKER, Feb. 29, 1996, at 1. According to the article, "[A] Justice Department antitrust complaint automatically blocks a pending merger." *Id.*

[28] *Id.* (indicating that the Justice Department sought to preserve the competition by ordering Wells Fargo to divest branches that could best serve small-business needs).

[29] *See* Jeanne Brokaw, *Technology a Key Factor-But Not the Decisive One*, AM. BANKER, Jan 29, 1996, at 18A (arguing that compatible technology greatly facilitates the consummation of bank mergers).

As long as Wells Fargo remained on the same regulatory time schedule as FBS, they would have had a high degree of credibility in the marketplace to vote down the FBS transaction. However, antitrust issues posed the major delay with the Wells Fargo transaction. The Federal Reserve requires, at a minimum, that a divestiture contract with a third party be signed prior to the closing of the merger.[30] Thus, early on in the process (even prior to the friendly merger contract between FBS and First Interstate), Wells Fargo had committed to divesting its own branches.[31] To emphasize the importance of due diligence, Montgomery Securities is now offering a package of 61 First Interstate branches.[32]

There are a number of lessons to be learned from the First Interstate transaction:

First, on the state level, the mega-mergers will focus on jobs.[33] Already, the presidential election, as well as *Newsweek* and, *Time* have focused on this issue.[34] A loss of 12,000 jobs will have a tremendous impact on the states and thereby will affect the mega-mergers.[35] Second, antitrust is being used more aggressively as both a defensive and offensive mechanism. The Department of Justice will analyze more acutely the participant banks' service businesses, moving beyond its traditional analysis of the respective small business and middle market lending portfolios of the participants. Third, the hostile bidder can win if

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[30] Barton Crockett & Daniel Kaplan, *Giant Banks From Across the U.S. May Join Bidding Today on Wells Branches*, AM. BANKER, Mar. 11, 1996, at 1 (stating that the Justice Department required Wells Fargo to divest 61 branches, the third largest divestiture in banking history, and the Federal Reserve required Wells Fargo to select buyers of the branches before consummating the merger).

[31] *See* Steven Lipin & Ralph T. King Jr., *First Interstate, Wells May Merge; Two California Banks Open Friendly Talks as Rival Deal Fades;* WALL ST. J., Jan. 23, 1996, at A3 (describing Wells Fargo's intention to sell $1 billion in deposits and branches if it was necessary to avoid anti-trust violations).

[32] *See* Crockett & Kaplan, *supra* note 30; *see also* Peter Sinton, *Wells Selling Branches; 61 First Interstate Outlets up for Grabs*, S.F. CHRON., Feb. 29 1996, at C1.

[33] *See* Jaret Seiberg, *Calming Conn. Critics, Fleet Pledges $208M for Community Development*, AM. BANKER, Sept. 12, 1995, at 3 (explaining that many State Attorney General's are requiring community reinvestment plans before approving mergers).

[34] Robert J. Samuelson, *Are Workers Disposable?*, NEWSWEEK, Feb. 12, 1996, at 47 (indicating that job insecurity is a greater problem than actual layoffs); Allan Sloan, *Take this Job and Cut it: How Wells Fargo Won the Battle of the Banks*, NEWSWEEK, Feb. 5, 1996, at 47 (indicating that branches will close and jobs will be lost); George J. Church, *Disconnected*, TIME, Jan. 15, 1996, at 44 (indicating that AT&T will lay off 40,000 employees - 13% of its workforce).

[35] *See* Sloan, *supra* note 1 (arguing that corporate downsizing may soon have a backlash effect).

it has superior economics and market creditability. Fourth, a hostile bidder can stay on a similar timetable to the target's chosen transaction.

The First Interstate transaction also involved a few other interesting issues. For instance, Wells Fargo had one tax issue. It had planned to do an exchange offer and then a second-step merger for those holders who did not exchange their shares. The first description in a filing with the Securities and Exchange Commission ("SEC") by Wells Fargo of the tax opinion to be rendered by Wells Fargo's counsel to Wells Fargo was a "should" opinion, stating that the transaction should be tax-free to First Interstate shareholders.[36] After First Interstate, FBS, and the SEC criticized this aspect of Wells Fargo's proposed transaction, reference to a "would" opinion appeared in a subsequent Wells Fargo filing with the SEC.

Whether or not the transaction would be tax-free depended upon whether the Internal Revenue Service would treat Wells Fargo's initial exchange offer and subsequent back-end merger as a single integrated transaction. Such treatment, in turn, depended on the closeness in timing of the two steps in the transaction, as well as the likelihood that the back-end merger would occur after the completion of the exchange offer.

Also, given its lack of a staggered board, [37] and in response to a potential consent solicitation by Wells Fargo to remove the First Interstate directors, First Interstate considered adopting a limited-time period "dead-hand" provision requiring a majority of the First Interstate directors serving on the Board prior to such consent solicitation to approve any transaction with Wells Fargo for a sixty-to-ninety day period.[38]

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[36] Such an opinion suggests the possibility that the transaction might not be tax-free to shareholders, thereby representing a less valuable investment option for First Interstate shareholders.

[37] Daniel Kaplan, *First Interstate's Defense Could Prove no Match For Wells' Offense, Experts Say*, AM. BANKER, Oct. 20, 1995, at 1.

[38] *See, e.g.* Steven Lipin, *J&J Goes to Court to Disarm Cordis of a Seldom-used Poison Pill Defense*, WALL ST. J., Oct. 27, 1996, at B2 (describing Cordis's poison pill shareholder-rights plan which said that only existing directors or their hand-picked successors can remove the pill, even if the existing directors are replaced in a proxy contest and analyzing the efficacy of this tactic).

This provision could be justified under Delaware law as an opportunity for the target to receive a higher bid.

In addition, I believe CAI Corporation's taking two seats out of nine on the Commercial Federal board is a fairly strong vote for change and obtaining shareholder approval of its proposal to put the company up for sale is indicative of the future in small and middle market thrifts and banks. There, again, as I said earlier, investors often see more downside than upside in the continued operation of the company as compared to a sale. I see aggressive shareholder activity being more likely to force the target into the arms of some of its competitors in order to gain cost savings and realize shareholder value.

CONCLUSION

Today, there is tremendous merger activity because of the cost savings to be realized. Wall Street is in love with the cost savings. I believe activity outside of the strict banking area will grow because, regardless of how strong the economy is, the financial services industry will be either asset poor or overcapitalized. Therefore, the attention will be on the asset producers. The second mortgage companies, the mortgage companies originating higher yielding loans to lesser credit quality borrowers, the consumer finance companies, and other specialized lenders will give banks the kinds of assets they need to grow. Also, whether or not other institutions can complete a successful hostile purchase accounting transaction will be determined in the future. A hostile pooling is extremely difficult because of dissenters' rights.

Wells Fargo had the advantage over FBS because they were able to do a purchase transaction as opposed to a pooling transaction.[39] A purchase transaction requires that the assets acquired be reflected on

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[39] Edward D. Herlihy et al., *The New Aggressive Era in Financial Institutions Mergers & Acquisitions*, MERGERS AND ACQUISITIONS OF FINANCIAL INSTITUTIONS 1995: AN UNPRECEDENTED YEAR OF CONSOLIDATION AN ANNUAL REVIEW OF LEADING DEVELOPMENTS (PLI Corporate Law & Practice Course Handbook Series No. 279, 1995) (explaining that Well's preferred a purchase transaction due to the greater flexibility that the acquirer has to buy back stock).

the acquiring corporation's books at their fair market value. The pooling of interest accounting method simply adds together the balance sheets of the two companies. Under the purchase method of accounting, the excess of the value of the consideration received over the fair market value of the assets acquired is recorded as goodwill. Wells Fargo was committed to the purchase method of accounting and to substantial stock buy-backs. A gap is created between their cash reported earnings per share ("EPS") and the Generally Accepted Accounting Principals reported EPS. Wells Fargo's management had a tremendous history of credibility on the gap between cash earnings and reported earnings and apparently, given the eventual spread between the Wells Fargo and FBS offers, Wells Fargo was successful in teaching the market that the cash flow was important.